

The rise of SMID banks

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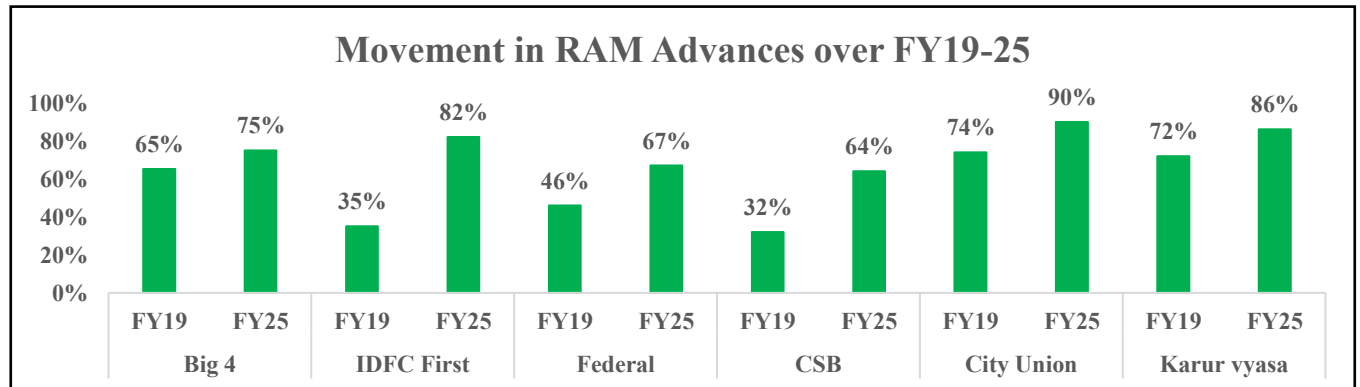
The rise of SMID banks

For the better part of the last decade, 'Long Large Private Banks' trade was not just consensus; it was the only strategy that offered “**sleep-adjusted returns**”. The logic was irrefutable: in an ecosystem plagued by corporate asset quality shocks and volatile credit cycles, scale was the ultimate proxy for safety. Tier-1 franchises commanded a scarcity premium, justifiably earning their 'Gold Standard' status by delivering predictable compounding while the broader banking universe grappled with solvency risks.

However, the post-COVID cycle has quietly dismantled this binary narrative. Under the cover of a benign credit environment, a structural change has occurred. The operating moats that once justified the historic valuation chasm—pristine asset quality, granular liability franchises, and top-decile return ratios—are no longer the exclusive preserve of the giants. As we deep dive, it becomes evident that while the 'Quality Gap' between large and mid-tier banks has structurally vanished, the 'Valuation Gap' remains at a historic anomaly, creating one of the most compelling mean-reversion opportunities in the sector today.

▪ The Great "Granularization" of Loan Books (FY19 vs FY25)

The defining characteristic of the FY19-FY25 cycle for Small & Mid-cap (SMID) banks has been the deliberate exit from consortium corporate lending. In FY19, banks like IDFC and Federal Bank carried heavy legacy corporate books (50-60%) that were prone to cyclical shocks. By FY25, these banks have successfully mirrored the "**Retail/SME First**" structure of larger peers like ICICI Bank. By excessively focusing on granular loan book, they have entered newer segments like gold loans, 2-wheeler/PV loans, micro-SME etc where the asset quality is case specific with stronger screening standards resulting in better return ratios (BIG 4- ICICI bank, HDFC Bank, Axis Bank, Kotak Mahindra bank; RAM - Retail, Agriculture, and MSME)

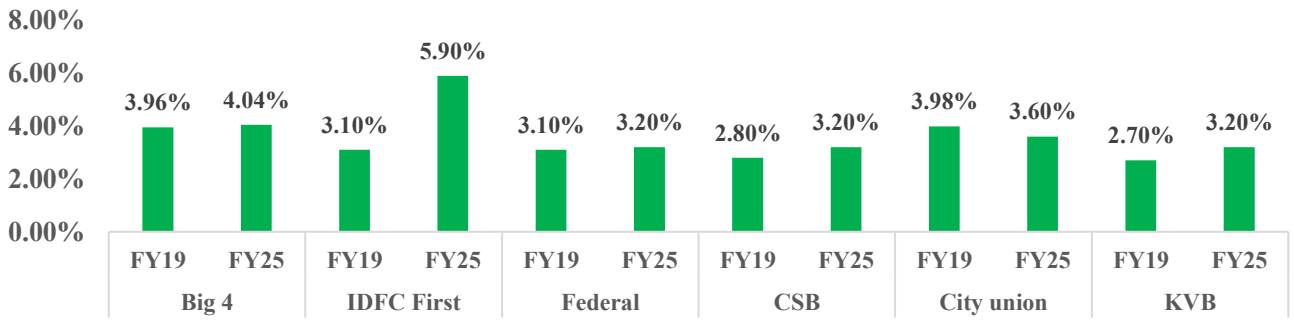


▪ The convergence in NIMS

Historically, the inability to raise low-cost CASA deposits was a key structural weakness for small banks. Realizing that disrupting the salary-account dominance of large banks is nearly impossible, the focus has pivoted from aggressive CASA acquisition to Granular Retail Term Deposits. The superior yields from a retail-led loan book allow these banks to absorb the premium pricing of Retail FDs over bulk deposits, effectively securing a stable liability franchise without chasing volatile wholesale funding. Despite weak industry CASA growth post covid due to cannibalization from capital markets, majority of the private banks expanded NIMS on account of stagnant cost of funds but expanding yields (Big 4 – Average of HDFC bank, ICICI bank, Axis Bank, Kotak Bank)



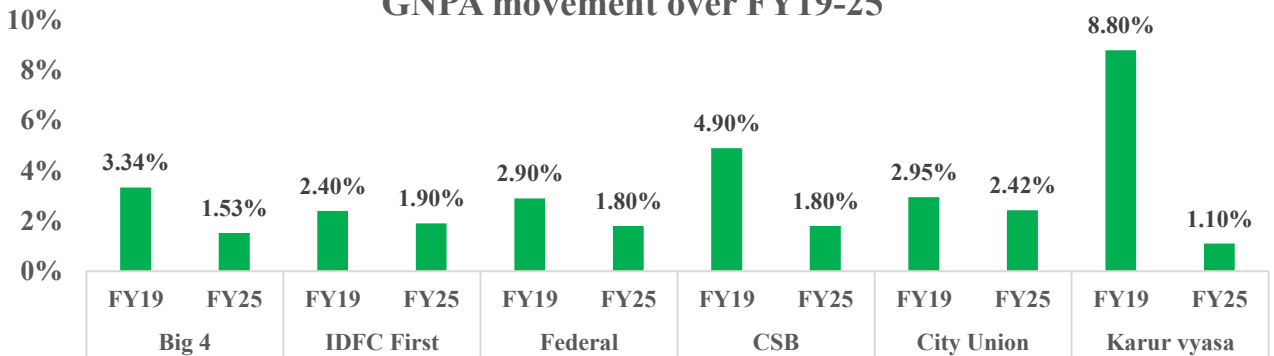
Movement in NIMS over FY19-25



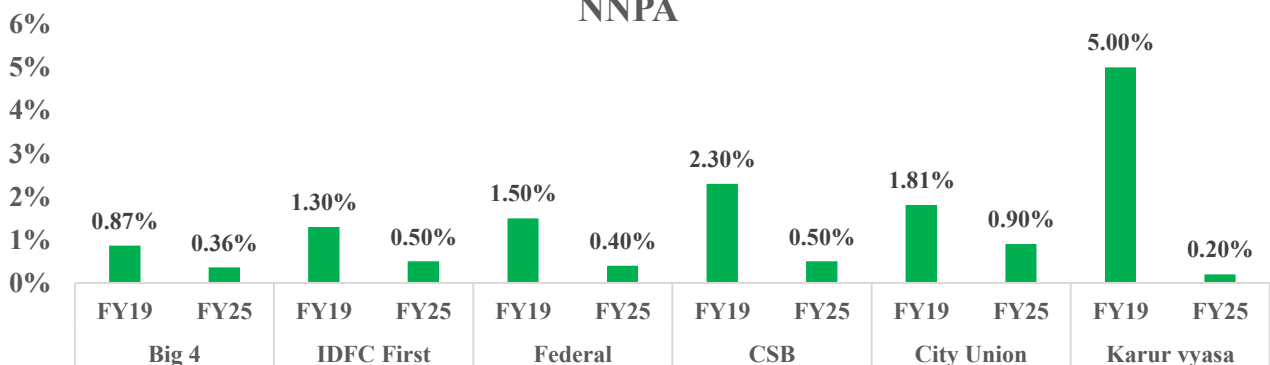
▪ The overdue cleanup of books

Pre Covid, small & mid-cap banks were structurally fragile due to **"Concentration Risk."** Lacking the balance sheet size to underwrite large projects alone, they often participated as minority members in large corporate consortiums (Infrastructure, Power, Steel). When a single large corporate account (like IL&FS, DHFL, or Reliance Capital) defaulted, it caused a disproportionate spike in the GNPA ratios of these smaller banks compared to large banks. By FY25, the narrative has flipped. Small banks aggressively exited consortiums, cleaned up legacy corporate books using COVID-era provisions, and pivoted to secured, granular lending (Gold, Home Loans, small SME). As a result, the "Asset Quality Gap" between Tier-1 and Tier-2 banks has vanished.

GNPA movement over FY19-25



NNPA



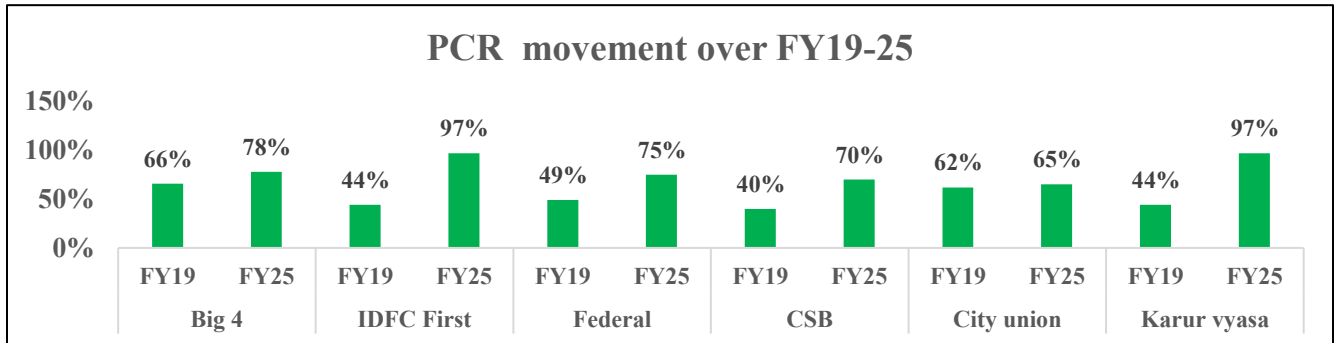


▪ **The Evolution of Underwriting: From "Judgment" to "Algorithm"**

The most structural improvement in the SMID banking space is the shift from **Decentralized Judgment (Branch Manager discretion) to Centralized Algorithms (Tech-led scorecards)**. This transition explains why asset quality has remained resilient despite high growth SMID banks have deployed significant capex toward digital infrastructure to sharpen both customer experience and underwriting standards. The integration of technology and AI has effectively bridged the gap in credit assessment, neutralizing the historical data advantage held by large-cap banks. Below is the Cumulative Opex Spend / Average Loan AUM (FY19-25).

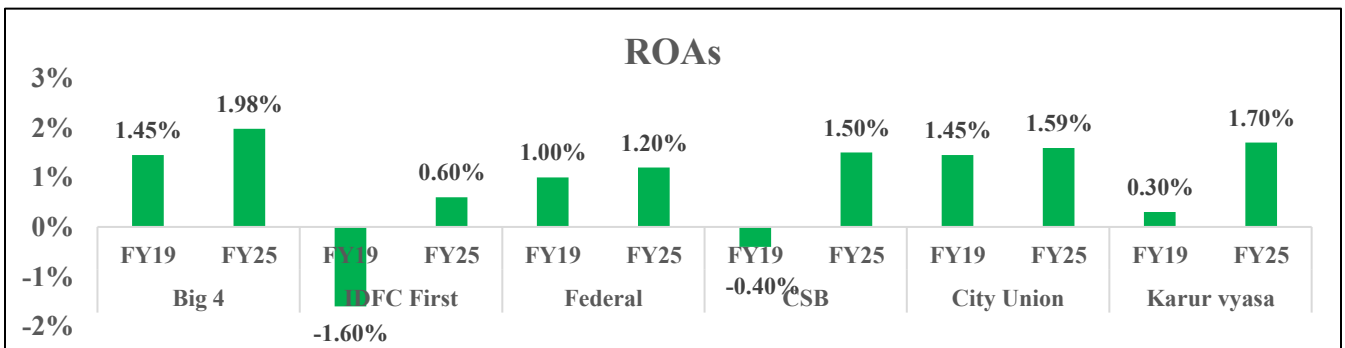
Bank	Opex Intensity
IDFC First Bank	~34.8%
AU Small Finance	~31.4%
Federal Bank	~21.5%

Along with tighter underwriting standards, SMID banks have also been very conservative in provisioning. PCR for most SMID banks has been at par with larger peers, ensuring sufficient buffers for asset quality shocks



▪ **A cumulative upliftment of ROAs**

The culmination of the structural shifts discussed—granular loan mix, tech-led underwriting, and the "Yield Shield"—is visible in the dramatic uplift of Return on Assets (RoA) across the Tier-2 banking universe. This convergence is not accidental but structural: by eliminating the "Corporate Drag" (credit costs dropping from >2% to <0.5%) and replacing it with high-yielding granular assets, these banks have structurally elevated their earnings floor. The market's historical view of "Small equals Low Return" is effectively obsolete; in FY25, smaller nimble franchises are close to matching the profitability metrics of the industry giants





▪ **Case for PSU banks**

Over FY20-25 even Public sector SMID banks have undergone a structural transformation, committing to sharpening underwriting & provisioning standards. However limited investments on branch network and tech spends often results in lower growth for PSU banks compared to private peers particularly on the retail side. To remain competitive, this legacy approach must shift toward active franchise building; those banks that successfully prioritize physical scaling and personnel depth alongside digital tools are most likely to capture sustainable market share. As these banks continue to uplift their ROAs toward the 1% threshold through improved operational efficiencies and lower credit costs, select franchises within the PSU space should also offer opportunities.

▪ **A long way ahead**

The outperformance of SMID banks is anchored on the hybrid model that large-cap incumbents burdened with high CD ratios and legacy infrastructure cannot easily replicated. By utilizing Open Banking APIs to partner with high velocity fintechs like OneCard and Niyo, SMID banks are acquiring premium urban consumers and MSME assets at a fraction of traditional customer acquisition costs (CAC). Concurrently, their aggressive branch expansion into underbanked Tier-2 and Tier-3 markets allows them to tap into fresh, low-cost CASA pools that are largely saturated for larger peers. This combination positions SMID banks to capture a disproportionate share of incremental credit demand, driving a projected advances CAGR of 18–25% versus the 12–14% expected for large-cap incumbents

Category	Avg. Advances CAGR (%)	Avg. Deposit CAGR (%)
	FY25-28	FY25-28
Small Finance Banks	22% – 25%	25% – 28%
Mid-Cap Private Banks	18% – 20%	17% – 19%
Large-Cap Private Banks	12% – 14%	13% – 15%

SMID private banks currently trade at significant discount to larger peers despite superior earnings & AUM growth profile. Precedents suggest that the market has previously ascribed premiums to smaller franchises such as AU Small Finance Bank based on the consistent delivery of high growth and profitability, irrespective of balance sheet size. Going forward, select franchises within the SMID universe that demonstrate an ability to scale while preserving return ratios could see their valuation multiples gradually decouple from the broader average

Particulars	FY 26 P/B	FY 26 ROA	FY 26 ROE
Small to mid-size banks			
Private sector banks	1.3	1.2%	12.1%
Small finance banks(Ex of AU SFB)	1.0	1.2%	10.2%
Mid to large banks			
ICICI Bank	2.9	2.2%	16.7%
HDFC Bank	2.8	1.9%	14.6%
AU Small finance bank	3.8	1.5%	14.1%



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